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International Economic & Energy Weekly

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25 January 1985

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Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence,* [redacted] 25X1

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Synopsis

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Although Western industrial countries remain the Communist Bloc's primary source of high-technology products, we believe the LDCs increasingly will become alternative sources of such items as well as compete with the West in certain high-technology sectors. 25X1

9 **LDC High Technology: Implications for West-East Technology Transfer** 25X1

In response to declining export-led growth in traditional sectors, a number of key LDCs are turning to the higher-value-added high-technology industries as central elements in their growth strategies. Although they face numerous obstacles, we believe over the next 10 years LDCs will be able to produce a growing number of items considered strategic by Western governments. 25X1

15 **OPEC: Crisis Deepens** 25X1

OPEC will meet on Monday in Geneva amid market expectations that it is powerless to halt the decline in world oil prices. We believe it is increasingly likely that OPEC will lower official prices some time this year. 25X1

19 **El Salvador: No Quick Fix for Economic Problems** 25X1

Because of the military and political constraints on President Duarte, we foresee that Salvadoran living standards will remain depressed during the remainder of his administration. Even if the insurgency ended soon and current aid levels were maintained, we judge that economic growth of 3 percent annually—which would maintain current living standards—is the best El Salvador can expect. 25X1

25 **USSR: The Economic Plan for 1985** 25X1

The 1985 Economic Plan presented to the Supreme Soviet late last year suggests real GNP growth of 3.5 to 4 percent, roughly double actual growth in 1984. Moscow is relying on continued gains in productivity and greater savings of energy and materials to achieve its targets. 25X1

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Perspective

LDC High Technology: A Growing Policy Concern [redacted] 25X1

Although Western industrial countries remain the USSR's and Eastern Europe's primary source of high-technology products, we believe the LDCs increasingly will become alternative sources of such items as well as compete with the West in certain high-technology sectors. Some LDCs already are acquiring technology and also are producing items that the West is attempting to keep out of Bloc hands. [redacted] 25X1

In our judgment, the LDCs will, to varying degrees, resist Western proposals to restrict their exports of sensitive high-technology products to the USSR and Eastern Europe and to limit their contact with Communist researchers. Many of these countries, for example, are investing heavily in high-technology industries and require foreign markets to make these investments viable. The heavy debt burdens some of them face only underscore their need for foreign exchange. If this judgment is correct, Communist access to advanced technologies will widen. [redacted] 25X1

Although we lack hard data for most of the high-technology sectors in the LDCs, in our judgment, South Korea, Taiwan, and, perhaps, Singapore could become competitive with certain high-technology industries in some Western countries in the next two to five years. Moreover, five to 10 years from now, the efforts by other LDCs in high-technology areas probably will also heighten competition for developed-country producers. [redacted] 25X1

We estimate the most likely areas for technological advances in the key LDCs over the next 10 years to be:

- Microelectronics design and production.
- Computer systems design and disk drive development.
- Telephone switching systems and millimeter wave communications devices.

Even if the LDCs do not widely produce state-of-the-art items, the Soviets may still use them as sources of older, but still strategically important, technologies for economic applications. Acquisition of these technologies from the LDCs will allow the Soviets to free up resources to develop or acquire technology for their military programs. [redacted] 25X1

Present developed-country government and business policies in some ways contribute to the Catch-22 situation faced by the LDCs. On the one hand, the West encourages high-technology industries in the LDCs through transfers of technology and private direct investment. On the other hand, Western governments are erecting barriers—such as orderly marketing arrangements, quotas, and tariffs—to the output of these same industries. Faced with shrinking access to industrial-country markets, the LDCs would see the Communist countries as an even more attractive alternative for their growing output of high-technology products. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

Progress on Qatar's North Dome Gas Development

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Turkish Decision on Nuclear Power Reactors

Turkey last week announced its decision to award a contract to AECL, a Canadian firm, to build its first nuclear power reactor on the Mediterranean coast at Akkuyu, according to the US Embassy in Ankara. The Turkish Minister of Energy also announced an agreement "in principle" with the West German firm Kraftwerk Union (KWU) to build a second nuclear power reactor at the same site. The Canadians agreed to build the 665-megawatt heavy water reactor—about 15 percent of Turkey's installed capacity—on a joint venture, direct investment basis, with AECL and its British and Turkish partners taking a 60-percent share in the project; the state-owned Turkish electrical utility will take the remaining 40 percent. AECL is to recover its capital over 15 years through electricity sales, at which time the facility will be turned over to Turkey. Contract negotiations for pricing the electricity are to be completed by May. 25X1

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International Finance

Philippines Misses IMF Performance Target

The Philippines is temporarily out of compliance with its recently negotiated $615 million IMF standby loan as a result of failing to meet the money supply targets. Manila's decision to lower domestic interest rates—which prevented the Central Bank from absorbing excess liquidity—resulted in a nearly 10-percent surge in the money supply by yearend. The IMF is postponing loan disbursements scheduled for March, and commercial banks may delay disbursements of new loans until the Fund determines that Manila is back in compliance. IMF disbursements could resume in May if Manila reduces the 25X1

money supply to target levels in the next several months. If it remains out of compliance, disbursements from foreign creditors will be suspended while the financial rescue package is renegotiated. The delay would plunge the economy further into recession and increase the possibility of domestic unrest. [redacted] 25X1

National Developments

Developed Countries

French Inflation and Interest Rates Fall

[redacted]

Consumer prices rose by 6.7 percent between the end of 1983 and the end of 1984, as compared with inflation of 9.3 percent for the previous year. Although above the 5-percent official target, inflation was below the rate most forecasters expected a year ago. Moreover, for the past three months the annual rate of inflation has been only slightly above the 4.5-percent target for 1985. Prime Minister Fabius has promised to remove all controls from industrial prices by March 1986, but we have little evidence that controls have been a major constraint on overall price levels. In addition, moderate wage increases and the possibility of a falling dollar could help to further moderate inflation this year. Interest rates have also fallen, probably in response to both declining dollar interest rates and the lower inflation rate. For example, banks have lowered their base rate to 11.5 percent from 12 percent, where it had been since August. [redacted] 25X1 25X1

Israeli Government Announces New Wage-Price Deal

[redacted]

The national unity government this week agreed on a program to replace the current wage-price freeze that ends 5 February. The new program is to last eight months and sets a 5-percent ceiling on price hikes for unsubsidized products. Prices for subsidized goods are to rise immediately—34 percent for fuel and approximately 25 percent for other basic commodities. Consumers will be partially compensated with a small pay boost and tax cut in January. This new arrangement essentially is a modification of the current deal and fails to address the more serious problems in the economy. [redacted] 25X1 25X1

Difficulties in making substantive economic policy are reflected in the government's proposed budget for the fiscal year beginning 1 April. Finance Minister Modai has presented a budget of almost $23 billion, $1.8 billion less than expenditures were running at the end of the year. Defense Minister Rabin is objecting to cuts proposed for his ministry, and other Cabinet officials argue the budget is still too large. In addition to agreeing on a budget, the government must adopt measures to enforce adherence to appropriations. [redacted] 25X1

Less Developed Countries

Morocco-IBRD Meeting Concluded

[redacted]

In recent consultations with the World Bank, the Moroccan delegation outlined stiff austerity measures that will result in real growth of no more than 2.5 percent annually through the end of this decade. By restructuring the 25X1

economy toward export-oriented industries, Rabat hopes to clear the way for new foreign financing. Over $2.5 billion in annual debt relief and concessional financing will be required over the next three years. With no planned growth in living standards, the program risks serious political unrest. The local media has played up the meeting, as evidence that Morocco's foreign donors support the adjustment program. The government is hoping that it can shift the blame for austerity to creditor demands in case lack of improvement in living standards provokes demonstrations. [redacted] 25X1

[redacted]

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Libyan-Nicaraguan Trade Expands

[redacted]

Libya and Nicaragua have signed a $15 million trade agreement, according to the US Embassy in Managua. The agreement provides for a barter exchange of Nicaraguan coffee, cotton, sesame, and bananas for Libyan crude oil. Tripoli delivered a shipment of crude last November as prepayment on the contract. This agreement highlights the sharp increase in Nicaraguan trade with Libya, Algeria, and Iran since 1982. The accord could help Managua offset declining prices for its primary exports, especially bananas. Qadhafi probably believes the deal also will help lessen Nicaragua's vulnerability to US pressure. [redacted] 25X1

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[redacted]

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Tunisian Price Increases Announced

[redacted]

The Government of Tunisia has raised retail prices on cigarettes and restructured rate schedules for water use in its ongoing effort to trim budget expenditures and curtail domestic consumption, according to the US Embassy. Increases of 7.5 percent and 5 percent, respectively, on imported and domestic cigarettes and 11.7 percent on water will pinch primarily wealthy Tunisians and the tourist industry. Most Tunisians do not have indoor plumbing and purchase domestically produced cigarettes. These measures come on the heels of similar increases on beef, milk, and alcoholic beverages and probably will be viewed as yet another move by the government to nibble away at living standards. [redacted]

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Pakistani Workers Leaving Saudi Arabia

[redacted]

Nearly 70,000 Pakistani workers left Saudi Arabia last year, and another 10,000 will leave in the next two months because of the downturn in the Saudi construction industry. [redacted]

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[redacted] The US Embassy in Saudi Arabia estimates about 500,000 Pakistani workers remain. Although their employment prospects are poor, the returning workers probably will not be a serious political problem for Islamabad. Their numbers are small compared with the total work force, and almost all of them have accumulated savings. More serious, however, is the loss of remittances. Pakistan's foreign exchange reserves have fallen from almost $2 billion to less than $1.0 billion over the past year. [redacted]

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Indian Economic Policy Changes Expected

[redacted]

Prime Minister Rajiv Gandhi's initial statements indicate a new sense of urgency to promote productivity and assimilation of modern technology. Although he has not announced any major policy initiatives since his landslide victory last month, he is studying recommendations to decentralize decision-making within the public sector and adjust foreign trade policy. Some of his newly appointed economic advisers also favor a further loosening of controls on the private sector. We expect that restrictions on use of foreign brand names and employment of foreign technicians will soon be eased, and the government may be less strict in regulating private production through the industrial licensing system. According to press and Embassy reports, Indian businessmen are impressed by the new government's pragmatism, but feel that bureaucratic resistance and political expediency will probably temper Gandhi's ambitious policy plans. [redacted]

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Indonesia Trying To Reverse Investment Slump

[redacted]

President Soeharto is reshuffling his investment team in a new effort to counter the sharp slump in investment last year. He is expected to name Ginanjar Kartasasmita, currently Junior Minister for the Promotion of Domestic Products, to head the Capital Investment Coordinating Board (BKPM) and already has appointed Eddy Sanyoto of the State Secretariat as deputy head. The new leadership is in the process of reviewing Indonesia's investment policies, but whether the move will succeed remains doubtful. Investment fell last year partly in response to domestic influences such as the elimination of tax holidays, uncertainty concerning the implementation of new

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tax laws, Jakarta's traditional redtape, poor market prospects for new investments, and Indonesia's declining attractiveness as an oil producer. Furthermore, Ginanjar probably will not devote his primary attention to investment, but will assume his BKPM duties in addition to retaining his present position. [redacted] 25X1

Communist

China Enters Asian Soybean Meal Markets

[redacted]

China recently sold 30,000 metric tons of soybean meal to South Korea at $38 below the US-delivered price of $195 a ton. Successive large soybean crops—USDA estimates the 1984/85 Chinese soybean crop at 10 million tons, one million tons over 1982/83 levels—and lack of transportation and storage within China could mean increased exports of soybean meal. Embassy reporting [redacted] indicate Chinese plans to penetrate Asian markets. Singapore, Malaysia, Thailand, Japan, and Indonesia are likely targets; and, to facilitate this, Beijing will open a commodity marketing office in Tokyo. [redacted]

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Japanese Trade With China Sets Record in 1984

[redacted]

Soaring Japanese exports to China pushed trade between the two countries last year up sharply from $10 billion in 1983 to a record $13.2 billion—the highest level since 1981. A 47-percent increase in exports gave the Japanese a record surplus. Steel exports reached 8.4 million tons. Sales of vehicles, home electric appliances, and whole plants and machinery were also strong. Imports were up 17.1 percent on stronger purchases of agricultural products and crude oil. Japanese officials expect trade to continue to rise this year, boosted again by strong Chinese investment demand. [redacted]

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LDC High Technology: Implications for West-East Technology Transfer [1] [redacted] 25X1

In response to declining export-led growth in traditional sectors, a number of key LDCs [2] are turning to the higher-value-added, high-technology industries as central elements in their growth strategies. Although they face numerous obstacles, we believe over the next 10 years LDCs will be able to produce a growing number of items considered strategic by Western governments. In particular, South Korea, Taiwan, and Singapore are at, or close to, the stage that will allow them to develop independently and produce on a commercial scale sophisticated items currently on the COCOM List and of potential interest to the Soviets. [redacted]

LDC High-Technology Policies

Most key LDC governments have programs, planned or in place, to stimulate expansion of domestic high-technology industries. The bulk of the programs is aimed at computers, microelectronics, and testing equipment. Almost all of these countries also apply varying degrees of import restrictions and tariffs to protect local industry. [redacted]

Financial Incentives. Policy measures designed to support domestic high-technology industries in the LDCs include:

- Preferential tax treatment for firms in priority industries.
- Government funding for research and development (R&D).
- Subsidized financing.

Soviet Interest in LDC High-Technology Development

A hardening of attitudes in the industrialized countries is further encouraging the USSR and Eastern Europe to seek alternative sources for high technology in the LDCs. The expanding manufacturing bases of a number of key developing countries, moreover, provide an opportunity for the Soviets to carry out both legal and illegal schemes to obtain Western technologies that might be more difficult or costly to obtain in COCOM countries. 25X1 *Opportunities for hostile governments to gain exposure to Western equipment and know-how multiply as the LDCs encourage the growth of industries like microelectronics, telecommunications, and automated manufacturing equipment.* [redacted] 25X1

We believe that, if the LDCs can successfully mass-produce militarily significant technology, the Soviets will actively pursue them as suppliers. Even if the LDCs do not widely produce state-of-the-art items, however, the Soviets will be inclined to use them as sources of older, but still strategically important, technologies for general economic applications. 25X1 *In early 1984 the COCOM allies agreed to address this threat by approaching countries they consider risky—such as South Korea, Singapore, and India—to ask them to strengthen their export control laws.* [redacted] 25X1

- Measures—such as government computerization programs, telecommunications system upgrading plans, and "buy local" incentives—designed to spur domestic demand for higher technology goods. [redacted] 25X1

[1] [redacted]

[2] Argentina, Brazil, Hong Kong, India, Indonesia, Malaysia, Mexico, Philippines, Singapore, South Korea, Taiwan, Thailand, and Venezuela. [redacted] 25X1

Support for R&D. According to data [redacted] five of the key LDC governments sponsor R&D bodies that assist private industry by acquiring technology, developing products, providing access to costly equipment, and transferring know-how to selected private firms for commercial implementation. Several, including Brazil, Taiwan, and South Korea, are establishing Silicon Valley–type regions with major government-sponsored research institutes as their centerpieces. We believe, however, very few of the key LDCs perform pioneering research in any high-technology area. Furthermore, although information is limited, we believe most do not have sufficient resources from either the public or private sectors to sustain industry development or R&D without substantial inflows of foreign capital. Although private firms in some LDCs—particularly South Korea, Taiwan, and Singapore—are allocating more funds to R&D, their efforts still revolve mainly around simple product innovations and reverse engineering. [redacted]

Skills Development. Investment in human capital to build the skilled work force required by high-technology industries over the medium to long term has received high priority. The key LDC governments—especially in Singapore, South Korea, and Taiwan—are supporting university and other training programs, purchasing scientific equipment for primary and secondary schools, and sending students abroad for study. Several countries have established joint training facilities with foreign governments and firms in high-technology fields. [redacted]

Review of High-Technology Industries

Although the key LDCs are attempting to enhance their technological capabilities across the board, several high-technology industries are in the forefront of these countries' development plans. [redacted]

Microelectronics. *Microelectronic devices are important because they provide increased performance and reliability in a widening range of items from toys to sophisticated military weapons systems.* 25X1 *We believe the Soviets are substantially* 25X1 *behind the West in key microelectronics technologies and lack supplies of key materials.* [redacted] 25X1

Multinational firms and some local companies in 12 of the key LDCs assemble, test, and package microelectronic devices ranging from transistors to integrated circuits (ICs) using finished wafers imported largely from US and Japanese parent companies. South Korea, Taiwan, Hong Kong, and India currently operate commercial front-end wafer production facilities, which start with electronic-grade silicon and end with finished wafers that may contain several hundred ICs. Similar plants in Brazil and Singapore should be operational by yearend 1985. Although these front-end plants are primarily high-cost, low-volume operations and are not currently forces in the commercial marketplace, we believe the establishment of such facilities demonstrates a growing ability to absorb sophisticated technologies. These front-end plants 25X1 currently produce a number of advanced microelectronic devices, including 64K DRAMs (dynamic random access memories) and, soon, 256K DRAMs in South Korea, and 8-bit CMOS (complementary metal oxide semiconductor) microprocessors in Taiwan and Hong Kong. [redacted] 25X1

If yield rates continue to improve, costs decline, and producers establish a reputation for reliability, we expect South Korea—and perhaps Taiwan and Hong Kong—to become a second-source supplier for segments of the advanced microelectronics market currently dominated by Japanese and US producers. 25X1 Even if this does not occur, we believe LDC microelectronics producers will inevitably move into segments of the market that are gradually being abandoned by developed-country producers, as is currently the case with liquid crystal displays. [redacted] 25X1 ongoing technology acquisition and R&D in Taiwan, South Korea, and Brazil point toward increasing 25X1 capabilities in 16-bit CMOS microprocessors, gallium arsenide semiconductor lasers, and advanced memory devices. [redacted] 25X1

Computers. *Because the West has a significant lead over the Soviets in the design and production of computer hardware, we believe the Soviets could benefit from exposure to technologies embodied in production facilities for advanced computers established in some of the key LDCs. They could also realize savings through the acquisition of relatively inexpensive computer systems from these countries.* [redacted]

Nine of the key LDCs produce small computers comparable to IBM PCs using largely imported components or kits, although some LDC support industries can now provide some important components, including ICs. Some domestic manufacturers in Taiwan, South Korea, and Brazil design their own computers for sale under local brand names, and other LDC firms produce for major multinationals, including IBM (US) and Hewlett-Packard (US). Available data indicate that India is the only current LDC producer of 32-bit computers, incorporating largely imported components, but Brazil will begin producing 32-bit machines sometime in 1985 and South Korea, in 1986. We believe Brazil, under a joint venture with Honeywell-Bull (France), will become the first LDC to have a mainframe computer industry, scheduled to start up by yearend 1985. In light of improved international market conditions, we believe Singapore will soon be the site of a manufacturing facility for an advanced 64-bit computer by Tata-Elxsi (India/US). [redacted]

Peripherals. *Peripherals with high capacities and fast access times—especially memory storage devices—are critical to the performance of computer systems. The Soviets would likely benefit from access to either Winchester disk production technology or the increased availability of low-cost Winchester or conventional disk drives from the key LDCs.* [redacted]

Nine of the key LDCs manufacture computer peripherals including intelligent terminals, monitors, disk drives, and impact printers, many produced under original equipment manufacturer (OEM) agreements for major international computer firms. Brazilian, South Korean, and Indian companies, however, produce a range of peripherals for their own growing computer industries. We believe most of the peripherals currently produced in the key LDCs are not sophisticated enough to be of military significance to the Soviets, but some disk drives manufactured in Taiwan, Hong Kong, India, Singapore, Brazil, South Korea, and Mexico probably are. [redacted] 25X1

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Software. *Sophisticated software—such as computer-aided design (CAD), computer-aided manufacture (CAM), and robotics programs—can enable computers to help design and produce highly complex items, such as microcircuits, nuclear weapons, and even more complex computers. Software capabilities in the Soviet Bloc are known to be weak, and even general application software could provide tangible economic and military benefits to the Soviets.* [redacted] 25X1

The software engineering capabilities of the key LDCs are limited mostly to the development of applications software for business, accounting, and educational usage, and customization of imported software packages. Three countries—India, South Korea, and Brazil—are currently writing or developing CAD and robotics software. We believe India has a short-term lead over the other LDCs in the software sector, but Singapore has mounted a training and investment drive aimed at turning the city state into Asia's regional software center by the end of the decade. [redacted] 25X1

Machine Tools/Robotics. *Industrial automation technologies provide improved product quality and reliability, lower costs per piece produced, and shorter production leadtimes. The Soviet Union seeks Western-designed programmable industrial control equipment.* [redacted] 25X1

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Although several LDCs—including India, Taiwan, and South Korea—are competitive exporters of basic manually operated machine tools, they produce only a few types of numerically controlled (NC) machine tools. [redacted] most of these countries' NC and computer numerically controlled (CNC) control units come from 25X1 25X1

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Japan, but Taiwan produces some CNC control units. Of the key LDCs, only South Korea commercially produces robots, and only two others—Taiwan and Brazil—currently have any plans for robotics production or R&D.

Telecommunications Equipment. *Sophisticated telecommunications equipment is of strategic concern because of its role in the coordination of complex and widespread military and economic operations. Stored-program-controlled (SPC) switching centers are important because of their ability to rapidly reroute calls in the event of disruption. Fiber optics equipment is of strategic interest because it is high capacity, does not emit electromagnetic signals that can be intercepted, and is radiation hardened. We believe the Soviets could benefit significantly from both access to Western telecommunications technology and information being purchased by the key LDCs, as well as through the importation of equipment manufactured in these countries.*

Although the manufacture of products such as telephone handsets is common, a few countries—such as South Korea, Argentina, Brazil, and Taiwan—are beginning to manufacture items, like digital SPC switching systems, incorporating state-of-the-art technologies that are generally subject to COCOM restrictions. India and Taiwan, and perhaps other LDCs, produce communications devices with frequency ranges above 18 gigahertz, also controlled by COCOM. Cellular radio telephones, now produced by Singapore and South Korea and soon to be produced in Hong Kong, are also currently covered by COCOM restrictions. In our judgment, even more of the key LDCs—particularly India—will begin producing and exporting SPC switching systems and fiber optics equipment, using technology acquired from Western firms, in the next five to 10 years.

Brazil, South Korea, Taiwan, and Singapore are developing or have plans to develop production capabilities in fiber optics communications equipment over the next five years. In our judgment, Brazil's fiber optics R&D program is currently the most advanced among the LDCs. Telebras, Brazil's national telecommunications company, is engaged in pilot production of first- and second-generation gallium arsenide and indium phosphide semiconductor lasers. One Brazilian firm began production of fiber optic transmission lines in August, and we expect several more firms to begin production in Brazil in the next five years.

Outlook

Just how much progress the key LDCs can make in high-technology fields is problematical. Our analysis indicates that the road toward high-technology development in the key LDCs is more akin to an obstacle course:

- Companies with inadequate financial and technical resources are facing bankruptcy and obsolescence.
- Weak linkages between government research institutes and private industry are causing companies to seek help from foreign sources.
- Protectionist policies and limited domestic markets are combining to create industries that cannot produce efficiently for either domestic consumption or export.

We believe even those countries with a chance to make a dent in international high-technology markets face problems. Inexperience often leads to slow response times, technology implementation difficulties, low yields, and high costs. As some of the key LDCs have already found, moving from laboratory prototype to mass production is more difficult than anticipated. We believe undeveloped marketing networks and no track record of reliability in high-technology production place the LDCs at a disadvantage even after a particular technology has been mastered.

Because of such obstacles, most LDCs are likely to do little more than replicate Western technologies. Yet, they will be able to produce an increasing number of items considered strategic by Western governments. Brazil and India, however, stand a

slightly better chance of making limited independent technological progress over the long term, and South Korea, Taiwan, and Singapore are likely to begin to develop advanced technologies independently and produce successfully on a commercial scale. [redacted] 25X1

[redacted] 25X1

OPEC: Crisis Deepens [redacted]

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[redacted]

Weakening Price Support

The meeting could be highly contentious as OPEC struggles for the eighth time in about two years to prop up prices. OPEC had hoped to preempt any major price action by Norway and the United Kingdom, by meeting again to address its recent agreement to realign light and heavy oil prices. Because the market apparently sees this and other recent efforts to defend the benchmark as ineffective, OPEC's official price structure is in serious jeopardy, and the organization's credibility is on the line. [redacted]

Another attempt to forestall an official price break could easily be thwarted as members continue to undermine the organization's production and pricing guidelines. Blatant violation of individual output quotas, public disagreement on price differentials, a wide proliferation of thinly disguised price discounts, and Nigerian intransigence on prices highlight OPEC's malaise. [redacted] 25X1

More ominous from OPEC's viewpoint, however, is the prospect that Saudi Arabia—the organization's most influential member—may not oppose a price cut. [redacted] 25X1 Yamani publicly claims that he is "flexible" on the price issue, a statement that reinforces industry skepticism that OPEC both can and will hold oil prices. 25X1

[redacted] 25X1

Pressures on OPEC

Lack of cooperation from non-OPEC oil producers is exacerbating the problem. OPEC probably regards the recent North Sea price moves as a provocation; at least five OPEC ministers have threatened a price war. Smaller non-OPEC producers—Mexico, Egypt, Malaysia, and Brunei—have been invited to attend OPEC's meeting as observers to enlist their support. In our judgment, what little support OPEC has managed to obtain from these producers will evaporate if the organization is unable to restore discipline within its own ranks. 25X1

[redacted] 25X1

The strength of the dollar also has been a mixed blessing for OPEC. Because oil is denominated in dollars, OPEC's purchasing power for foreign imports has remained relatively stable despite declining oil revenues over the past year. At the same time, however, major consumers in Western Europe and Japan are paying more for dollar-priced oil, which has held recovery in oil demand below the rate of economic growth. [redacted]

The oil market outlook also promises little respite. The recent cold snap temporarily boosted spot prices, but OPEC faces a seasonal downturn in demand in early spring. Non-Communist oil consumption is expected to increase only marginally this year because of slower economic growth. Demand for OPEC oil—estimated at 17.3 million b/d by the organization's Economic Commission Board—will at best match 1984 levels. At the same time, non-OPEC producers are expected to continue to step up production. Substantial excess oil productive capacity will encourage oil companies to hold minimal oil stocks and force OPEC to allocate production to meet seasonal swings in demand, a difficult task in the past. [redacted]

Unresolved Issues

Divergent self-interests within OPEC make consensus difficult and sometimes unattainable. At its meeting on Monday, OPEC will again attempt to deal with Nigeria, which has operated outside the fold for nearly two years and has recently come under renewed customer pressure to cut prices again. [redacted] Nigeria, however, is unlikely to bow to Saudi pressure and probably will continue to cite its bleak economic outlook and dependence on oil revenue as reasons for noncompliance. [redacted]

OPEC members remain divided on resolving the disparity between the current system of price differentials [1] and actual market conditions. Many members are promoting elimination of the differentials system to avoid pricing chaos and to help stabilize the market. They know, however, that dealing with differentials requires lengthy negotiation. OPEC's differentials committee met on 20 January in Riyadh and will meet again in Geneva this weekend to consider proposals to realign prices. We expect that a number of proposals will be put before the committee; it is unclear if any has enough support to win approval at the ministerial meeting: 25X1

- The Kuwaiti News Agency reports that the differentials committee will recommend lowering the benchmark price to $28 per barrel; and OPEC's News Agency denies the report.

- Algeria, the United Arab Emirates, and Qatar favor large price cuts—as much as $1.50 per barrel—for light crudes to make their oil competitive with more attractively priced heavy oils.

[redacted] 25X1 25X1

- Venezuela opposes any further price increase on heavier crudes and is not likely to compromise.

- Libya and Iran are likely to dissent on any price cut.

- Some ministers [redacted] may propose basing prices on a basket of crudes with a flexible system of differentials that changes with market conditions. [redacted] 25X1 25X1 25X1

Failure to come to grips with the thorny issue of differentials, however, will put even more pressure on OPEC to abandon the benchmark price. At the

[1] Differentials are the margins by which prices of various crudes differ from the price of the OPEC benchmark crude—Saudi Arab Light 34° API. These differences reflect variations in crude quality and proximity to major markets. [redacted] 25X1 25X1

same time, any solution to the differentials problem probably will entail a downward adjustment to the official price. The impact of such a cut will in large measure be psychological. According to industry estimates, about half of OPEC oil exports are already being sold outside the official price structure, and virtually all non-OPEC sales are at less than the benchmark. [redacted]

Within the next 12 months, OPEC's attempt to control output could be further challenged by increased supplies from Iraq. The US Embassy reports that Iraqi Oil Minister Taqi believes that Iraq's quota will be increased by the time its pipeline link in Saudi Arabia is completed in late 1985. [redacted]

Price Outlook

Some ministers may again raise the possibility of a price war with non-OPEC producers or a switch to spot market pricing at next week's meeting. We do not consider a price war a serious threat because of the economic strains members would suffer. Moreover, a switch to spot market pricing by OPEC would give the market an element of volatility that the organization has strived to avoid. Nevertheless, we cannot rule out the possibility that the Saudis have reached the point where they believe a sharp price drop and the ensuing loss of revenue is the only way left to restore discipline [redacted]

As in the past, much of the burden of restoring stability to the market falls on the Saudis. We believe that the Saudis are becoming less willing to support the current pricing structure but would continue to do their part if other members provide firm assurances of production and pricing restraint. [redacted] To prop up prices, the Saudis have cut their output by over 5 million b/d since 1981, and, with production now at about 3.5 million b/d, Riyadh may feel that its own financial interest outweighs any gains from defending OPEC's current price structure. In our view, all these factors portend a price drop—perhaps a substantial one—this year. [redacted]

[redacted]

OPEC: Crude Oil Production *Million b/d*

	1984 First Half	1984 Third Quarter	1984 Fourth Quarter	December 1984 [a]	January 1985 [b]
Total	**18.6**	**17.0**	**16.6**	**16.6**	**16.1**
Algeria	0.7	0.7	0.7	0.7	0.7
Divided Zone	0.5	0.5	0.4	0.4	0.4
Ecuador	0.2	0.2	0.3	0.3	0.2
Gabon	0.2	0.2	0.2	0.2	0.2
Indonesia	1.5	1.4	1.3	1.3	1.3
Iran	2.6	2.2	2.1	2.3	2.1
Iraq	1.1	1.2	1.3	1.3	1.3
Kuwait	1.0	0.9	0.9	0.9	0.9
Libya	1.2	1.1	1.0	1.0	1.0
Nigeria	1.4	1.2	1.6	1.7	1.4
Qatar	0.4	0.4	0.3	0.3	0.3
Saudi Arabia	4.9	4.0	3.8	3.5	3.5
UAE	1.3	1.2	1.2	1.2	1.2
Venezuela	1.7	1.7	1.6	1.6	1.6

[a] Preliminary.
[b] Estimate.

[redacted]

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El Salvador: No Quick Fix for Economic Problems [redacted]

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Because of the military and political constraints on President Duarte, we foresee Salvadoran living standards remaining depressed during the remainder of his administration. The 1.5-percent increase in real GDP in 1984—the first economic growth in five years—resulted almost wholly from higher government spending and increased foreign aid. Current levels of foreign economic assistance—$550-600 million per year—would maintain annual growth at just 1 percent through 1989 in light of the current security situation. Even if the insurgency ended soon and current aid levels were maintained, we judge that economic growth of 3 percent annually—which would only maintain current living standards—is the best El Salvador can expect. [redacted]

El Salvador: Foreign Economic Assistance — *Million US $*

	1981	1982	1983	1984 [a]
Total	**326**	**477**	**502**	**605**
United States	100	178	242	335
Inter-American Development Bank	61	48	85	100
International Monetary Fund	43	68	35	0
Venezuela	41	39	50	40
Others	81	144	90	130

[a] Estimated.

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[redacted]

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Duarte Takes Over

When Duarte was inaugurated last June, he took over a crippled and beleaguered economy. His strategy since then has been largely one of delaying unpopular economic adjustments until progress is made in stabilizing the military situation. Meanwhile, substantial success in increasing foreign economic assistance has enabled him to postpone making tough economic choices. [redacted]

The ruling Christian Democrats have long advocated an activist and redistributive role for the government in the economy. Duarte, however, is constrained from instituting major structural changes by his need to maintain crucial support from the private sector and the military. As a result, he has avoided confrontations with business, and some initial hostility appears to be fading. [redacted]

Duarte's ability to gain private-sector support is constrained by pressures from organized labor, which uniformly backed his election. Labor expects social reforms to continue under the Christian Democrats, and they are eager to recoup losses in real income. Recognizing Duarte's dilemma, the guerrillas are trying to foment labor unrest through the unions they control. Union activism and strike activity increased prior to the spring elections and continued throughout 1984. In a budget-busting move, Duarte was pressured into granting public-sector employees a large wage increase in July to avoid strikes. [redacted] 25X1

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Duarte has balked at opening discussions with the IMF on a new standby arrangement because of his reluctance to impose austerity measures such as a tax increase and currency devaluation, which he views as harming the poor. Duarte, however, has told US Embassy officials he plans to ask for a tax increase after the March National Assembly election and to officially devalue the colon by the end of 1985. He has also shown some flexibility on the exchange rate issue by expanding the use of the parallel foreign exchange market for foreign trade 25X1

El Salvador: Balance of Payments

Million US $

	1982	1983	1984 [a]
Current account balance	−152	−96	−128
Trade balance	−183	−155	−183
Exports, f.o.b.	700	737	798
Coffee	403	402	440
Cotton	45	56	35
Sugar	16	40	45
Manufactured goods to CACM countries	174	168	180
Other	62	71	98
Imports, c.i.f.	883	892	981
Net services	−140	−151	−175
Net transfers	171	210	230
Capital account balance	222	276	101
Net official capital	267	274	103
Net private capital	−44	−4	−7
Errors and omissions	−1	6	5
Net change in international reserves	**70**	**180**	**−27**

[a] Estimated.

in the second half of 1984. We estimate that 35 percent of foreign exchange transactions now take place at the parallel rate of US $1=4 colones, as compared with 15 percent of the transactions when Duarte took office—an effective devaluation of 10 percent.

Preliminary Central Bank estimates put real GDP growth at 1.5 percent last year. Increased imports spurred manufacturing, and high government spending boosted utilities, transportation, and construction. Poor agricultural performance attributed to weak incentives, and sabotage by the insurgents was largely offset by the continued growth in the government sector. Despite higher spending, particularly for the military and public-sector wage increases, per capita income fell for the sixth consecutive year, and unemployment remained at 35 percent.

A second year of growth in export earnings and another large increase in foreign aid allowed the first real import growth since 1978. In addition, worker remittances increased, nontraditional exports grew by 20 percent, capital flight remained in check, and inflation rates dipped slightly. Still, the import expansion was capped by the substantial rise in debt servicing—to 25 percent of exports—as the grace period ended on many loans. 25X1

Meager Economic Prospects

The economy is so depressed, and the impediments to recovery so large, that we see only a small chance that Duarte will be able to increase economic growth much during the rest of his tenure, which ends in 1989. Unless the security situation substantially improves, we expect economic growth to stay at an average of about 1 percent annually. Even if the war ended soon, we project that import constraints and the bleak business climate would hold economic growth at the rate of population increase. Only the best of circumstances—including an unlikely jump in already unprecedented levels of foreign aid—would allow the economy to expand by more than 3 percent, thus raising the standard 25X1
of living. 25X1

To have any chance for boosting living standards, Duarte must gain the support of international creditors and local business and labor leaders. To do this, we believe El Salvador would have to adopt the kind of budget, trade, credit, and foreign exchange policies that the IMF would endorse. 25X1 At the same time, Duarte would have to overcome his antibusiness image without alienating labor. Although international creditors will expect higher taxes, wage restraints, and a sharp currency devaluation, business leaders will push for financial concessions as labor demands a quick boost in wages. Organized labor and consumers will resist a devaluation because of its expected impact on inflation. Achieving all of this would require considerable skill and luck. 25X1

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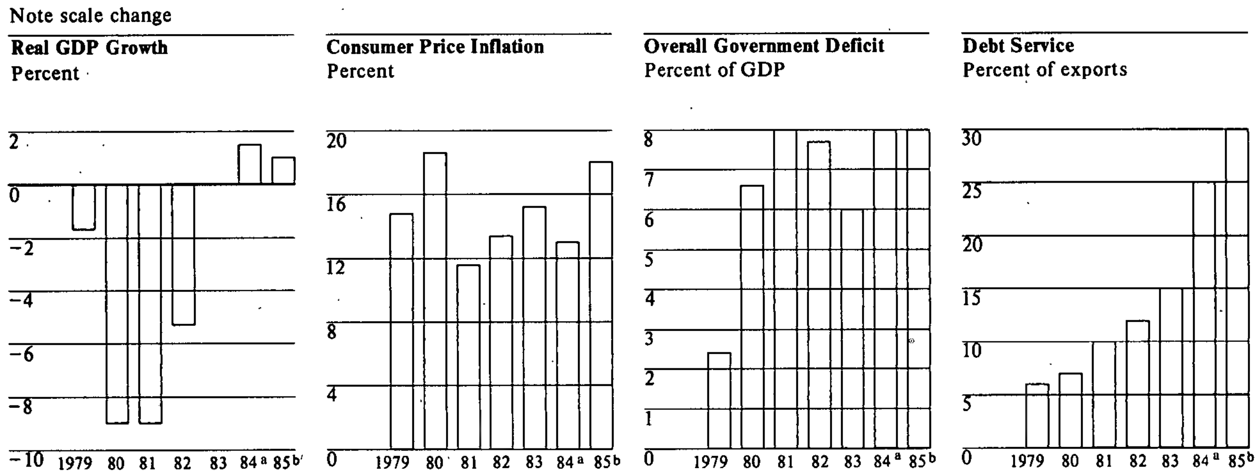
El Salvador: Economic Indicators, 1979-85



[a] Estimated.
[b] Projected.

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Duarte's success in overcoming embedded economic problems will be critically dependent on the status of the insurgency and on the financial support of foreign lenders and donors. To assess El Salvador's medium-term potential, we have analyzed import requirements under alternative military situations. In each scenario we have targeted an average annual 1-percent growth during 1985-89 as well as a 3-percent growth path and examined the implicit domestic savings and foreign financial requirements. We then estimated El Salvador's ability to finance required imports, with and without increased foreign aid.

Scenario I—No Major Change in the Insurgency

In this case, guerrilla forces continue to demonstrate their military capabilities in the face of ongoing aggressive Army operations, despite Duarte's peace efforts. We would expect them to step up attacks on economic targets and efforts to disrupt key coffee, cotton, and sugar harvests. The Duarte government continues to resolve economic policy differences with labor and business through compromise but is still constrained from bold initiatives or controversial decisions. In this environment, only those businessmen willing to take high risks for potentially large profits would commit resources to the economy. Some others would try to cut their losses, reviving the flight of capital and human resources although at much lower levels than in the past. 25X1

Even for El Salvador to achieve an annual 1-percent growth through 1989 in these circumstances, it would be necessary to finance rising current account deficits. We calculate that 5-percent growth in import volume would be needed to sustain 1-percent economic expansion. Imports would be needed first to restore depleted stocks of industrial raw materials, intermediate goods, agrochemicals, and spare parts, and then to replace damaged machines and equipment and begin to 25X1

expand the capital stock. Meanwhile, in our judgment, export earnings still would expand by no more than 5 percent yearly because of continued guerrilla interdiction and uncertain world commodity markets.

If, as we expect, foreign investors and lenders remain chary of El Salvador, the burden will fall to foreign official assistance to fill balance-of-payment financing requirements of $550-600 million each year. These funds would be required to cover annual trade and service deficits of $300-350 million yearly and public debt amortization obligations and capital flight projected to average $250 million per annum. To meet these requirements—and achieve just 1-percent annual growth through 1989—foreign financial flows from official sources would have to stay at current levels for the next five years.

To achieve annual 3-percent economic growth—just enough to offset population growth—during 1985-89, El Salvador would have to finance substantially higher foreign payments deficits. We calculate that total imports would need to rise 12 percent per year. This would increase the trade and services deficit to the $700-750 million range. In this circumstance, we expect that the increased debt service caused by greater borrowing would be largely offset by lower capital flight encouraged by new opportunities offered by the higher economic expansion. Nevertheless, just to achieve 3-percent growth would require $950 million to $1 billion each year in foreign assistance—a 60- to 65-percent increase over current levels.

Scenario II—Improved Security Situation

A reduced guerrilla threat—either by mutual cease-fire or by a shift in the tactical balance in favor of the military—would further encourage the private sector, as long as the insurgents' military efforts are not replaced by equally violent terrorism and economic sabotage. Even if the war ended, however, an enormous effort would be required to revitalize the economy. The US Embassy estimates that restoring basic government services by rebuilding bridges, electrical and water systems, and replacing damaged buildings and equipment would require $150 million in public investment. Gearing up privately owned factories and boosting agricultural production would likely require additional money and a much longer time. 25X1 25X1

Some short-term economic gains would be achieved by more fully utilizing existing productive capacity. Reduced risk of terrorist attacks would encourage farmers to plant more acreage and enable them to attain substantially greater crop harvests. In addition, enhanced government protection of electric power facilities would permit significant increases in industrial production. We calculate that rising output of cash crops and manufactured goods might spur an expansion of exports by about 10 percent yearly. 25X1

We believe an expansion of private capital formation and commercial bank credit also would occur, but slowly. Domestic and foreign businessmen would be likely to proceed cautiously until they were convinced that the improved security conditions would endure. At the same time, however, the public sector would be in a better financial position to contribute to economic recovery through rechanneled defense spending and higher export tax revenues. 25X1 25X1

In this situation, El Salvador could achieve 1-percent average economic growth with foreign assistance of about one-half of current levels. Higher exports would add an average $120 million per year to foreign exchange earnings during 1985-89, reducing the trade and service deficit to $200-250 million per year. We also believe that these circumstances over time would encourage Salvadorans to bring money back into the country and that renewed commercial credits and foreign investment would supply another $120 million, or so. 25X1 25X1

In the 3-percent economic growth case, we calculate that the goods and services deficit would total $580-630 million per year. We would also expect a pickup in private capital flows as opportunities for profits encourage local and foreign investors. We anticipate that the best El Salvador could expect

from foreign commercial bankers would be $200 million per year, twice the prewar average but roughly equal to principal repayments. Despite increased private financial flows, foreign aid of roughly $550-600 million per year would still be required. 25X1

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USSR: The Economic Plan for 1985

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The 1985 Economic Plan presented to the Supreme Soviet late last year suggests real GNP growth of 3.5 to 4 percent, roughly double actual growth in 1984. The plan is ambitious and projected growth in both industry and agriculture indicates that Moscow is relying on continued gains in productivity and greater savings of energy and materials to achieve its targets. Although the broad goals of the plan could be reached, several individual targets such as those for oil and coal almost certainly will not be met. The announced 12-percent increase in defense spending—the first since 1969—is a political gesture because the official budget only covers a small fraction of total military expenditures.

USSR: GNP Growth *Percent*

	1981	1982	1983	1984 [a]	1985 Plan
GNP	**1.9**	**2.6**	**3.6**	**1.5-2.5**	**3.5-4.0**
Industry	2.3	2.4	3.7	3.0-4.0	3.9 [b]
Agriculture [c]	−0.3	6.2	6.5	−1.5-−0.5	6.7 [b]

[a] Preliminary.
[b] Gross value of output.
[c] Excludes intra-agricultural use of farm products but does not adjust for purchases by agriculture from other sectors.

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Industry, Energy, and Agriculture

The plan calls for a 3.9-percent increase in industrial output, led by a 6.5-percent increase in machine building and metalworking. The leadership recognizes that these sectors are the key to the modernization of the economy as a whole as well as the source of advanced technology for defense. The portion of machinery production—consumer durables—ticketed for consumption is scheduled to grow by 6 percent, somewhat below the target for the sector as a whole. The chemical industry is another important branch in which above-average growth is planned (5 percent). Output of steel pipe is scheduled to rise by 4.3 percent while steel generally is targeted at about 1.2 percent. Within the vital energy sector:

- Production of natural gas is expected to continue the rapid growth of the last several years, with an 8-percent increase slated for 1985.
- Much slower growth is planned for oil and coal—2 and 1.6 percent, respectively.
- Electric power is scheduled to rise by 3.7 percent in 1985, just below the rate of increase for industry as a whole.

The target for gas probably will be reached or slightly exceeded, but the goals for oil and coal are not plausible. Oil output in 1984 did not reach planned goals and fell below the previous year's level. With output from oilfields outside West Siberia declining and production from the key West Siberian region flattened out, prospects for holding total oil output at current levels are not promising. Additional capital and the commitment of vast amounts of other resources are unlikely to effect a marked improvement in the near-term outlook for oil production. Coal production will be limited by investment priorities that favor gas, oil, and nuclear development, the slow pace in exploiting Siberian reserves, and increasingly difficult underground mining conditions. 25X1

According to the 1985 plan, the value of farm output is to grow by nearly 7 percent. Even if the 1985 goal is reached, average annual agricultural output in 1981-85 will be 6 percent below the original 1981-85 plan. Consequently, output in the food industry is likely to fall below the 1981-85

USSR: Targets for Selected Commodities, 1985

	Original Target [a]	New Plan [b]
Electricity *(billion kilowatt-hours)*	1,555	1,540
Oil *(million metric tons)*	630	628
Gas *(billion cubic meters)*	630	632
Coal *(million metric tons)*	775	726.2
Rolled steel *(million metric tons)*	118	109.4
Steel pipe *(million metric tons)*	21.9	19.7
Plastics and resins *(million metric tons)*	6.1	5.2
Fertilizer *(million metric tons, nutrient content)*	36-37	33.6-34.0

[a] As presented in 11th Five-Year Plan in 1981.
[b] As presented in late 1984.

Selected Soviet Capital Investment Statistics *Percent growth*

	1981	1982	1983	1984 Plan	1985 Plan
Total capital investment	**3.8**	**3.6**	**5.7**	**3.9**	**3.4**
State capital investment	4.2	3.4	5.4	5.2	5.5
Commissionings of new production capacity in state sector	0.3	5.3	5.9	5.8	7.6

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plan, and consumer gains in per capita availability of desired farm products such as meat and butter will continue to depend on imports.

Fixed Capital Investment

The outlook for fixed investment is particularly confused. Initial plans for such investment to grow in 1981-85 at an average annual rate of less than 2 percent were apparently abandoned before the plan was even under way. Actual growth has averaged over 4 percent a year, faster than the pace at which GNP has increased.

The rapid rise in investment in the last few years demonstrated leadership recognition that productivity gains require much more investment than they had originally thought. The 1985 plan, however, calls for a slowdown in fixed investment—below the rate of recent years and below the projected 3.5-percent rise in national income this year. Furthermore, according to the plan, almost all of the increase in national income will come from personal and public consumption.

It is difficult, however, to reconcile the planned increase in total investment of 3.4 percent with another 1985 goal—a 5.5-percent increase in state capital investment.[1] The planned acceleration in machinery output also seems inconsistent with a slowdown in investment growth. 25X1 25X1

About one-third of total investment will continue to be devoted to the "agro-industrial complex"—agriculture and supporting industries. The Supreme Soviet session indicated that there would be substantial increases in investment in food processing and storage. Moscow may be trying to get the original plan for agricultural support back on track. 25X1 25X1

As stated priorities, the regime singled out the energy, raw materials, and machinery sectors. Residential construction also appears to be receiving greater priority. After stagnating for years, housing construction jumped to a record 112 million square meters in 1983 and rose again in 1984 to 113.7 million square meters. Much of the increase represents additions to rural housing under ambitious targets set in the 1982 Food Program. The 1985 target is 114 million square meters which, if met, would overfulfill the housing goal for 1981-85 by 5 percent. 25X1 25X1

[1] Since state capital outlays account for almost 90 percent of total fixed investment, a 3.4-percent increase for the latter implies a decline in nonstate investment of about 15 percent. In 1982 and 1983, total investment rose faster than state capital investment. 25X1

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Consumption

Consumption-related goals—including increases in retail sales, output of light industry, national income, and real per capita income—suggest an increase in real consumption in 1985 of about 4 percent, faster than the estimated 1984 rise of about 2.5 percent. The prospects for supplies of consumer goods to support such a substantial increase in consumption are not good, however. Retail sales goals were not met in 1983 or 1984, and the Soviets have fallen short of the light industry target for several years. Perhaps most important, the reduced crop production in 1984 could affect overall consumption in 1985 because food accounts for about half of total personal consumption.

Defense

As usual, the 1985 plan contains no useful clues as to defense spending and its share in GNP. Finance Minister Garbuzov told the Supreme Soviet that there would be a 12-percent increase in the defense budget this year, the first boost in the official figure since 1969. The announced figure is a small fraction of what the Soviets actually spend on defense, however, and the assertion that military expenditures will go up probably should be regarded as a political gesture to back Soviet claims of a need to "strengthen" defense. A rise in defense spending cannot be ruled out. The projected acceleration in the growth of machinery production, for example, is not inconsistent with such a development.

The Economy and Foreign Trade

The USSR cannot look to foreign trade for much help in boosting economic growth in 1985. The USSR's trade position vis-a-vis Eastern Europe is likely to improve slightly, but the recent growth in its hard currency surplus with the non-Communist world will subside. Trade turnover with the Communist countries is expected to increase to 60 percent of all Soviet trade, up from 54 percent in 1980. Moscow intends to reduce the net outflow of resources to Eastern Europe by reducing its trade surplus with them somewhat and through greater East European contributions to mutually beneficial investment projects on Soviet soil. 25X1

Trade with non-Communist countries is likely to remain at roughly the 1984 level. Probably record levels of grain imports will be offset by reduced imports of machinery and equipment. Sagging oil production and slack market conditions will cut into oil sales to West European countries that have been the major source of hard currency earnings. Weakening prices for Soviet energy exports, however, will be largely offset by lower prices of agricultural and steel pipe imports. 25X1

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Implementation of Goals

With a continuing labor shortage the leadership is counting on productivity gains to provide the impetus for growth in 1985. The emphasis is on efficiency and conservation in use of labor and material resources. The need for discipline remains a prominent theme, as does the importance of saving raw materials and fuel. 25X1

A management experiment initiated at the start of 1984 in five industrial ministries is being extended to an additional 21 ministries this year. The experiment seeks to improve planning and management by giving enterprises greater autonomy and by making fulfillment of contracted deliveries the main performance indicator. 25X1 Although the regime claims some success, the wider application to additonal industrial and consumer enterprises may not have much impact on the economy as a whole because only a small proportion of total economic activity—in industry, 15 percent—will be included in the experiment. 25X1

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